## 2. *Reserve Bank of India (RBI)*

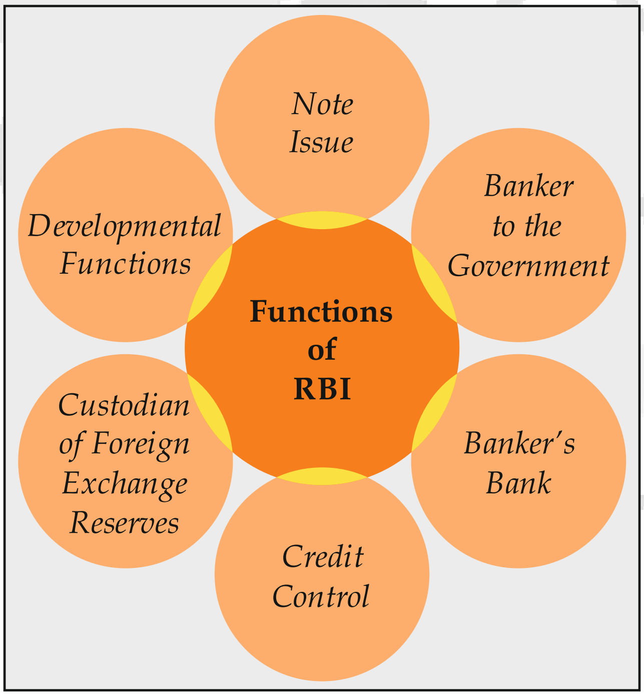
The Reserve Bank of India is the apex financial institution of the country's monetary system.

The Reserve Bank of India (RBI), as India's central bank, was established on 1st April, 1935 under the Reserve Bank of India Act, 1934.

*In 1921, the Imperial Bank of India was set-up by the amalgamation of the three Presidency Banks,* which performed a few central banking functions, though primarily it remained as a commercial bank. Specifically, the Imperial Bank served as a banker to the government and in some capacity as banker's bank till the establishment of the Reserve Bank of India in 1935.

A fresh bill to this effect was introduced in the Indian Legislative Assembly on September 8, 1933. The bill was passed and received the assent of the Governor-General on March 6, 1934 and became the Reserve Bank of India Act, 1934. In accordance with the Act, *the Reserve Bank of India was constituted and it commenced operations from April 1, 1935.*

**Functions of RBI**




The Resever Bank of India is performing variuos functions related to monetrary management, banking operations, foreign exchange, developmental works and research on problems of economy.

The following are some of the major functions normally performed by the Reserve Bank of India :

1. **Note Issue :** Being the Central Bank of the country, the RBI is entrusted with the sole authority to issue currency notes after keeping certain minimum reserve consisting of gold reserve worth Rs. 115 crore and foreign exchange worth Rs. 85 crore. This provision was later amended and simplified.

2. **Banker to the Government :** *The RBI is working as banker of the government and therefore all funds of both Central and State Governments are kept with it*. It acts as an agent of the government and manages its public debt. RBI also offering "ways and means advance" to the government for short periods.

3. **Banker's Bank :** The RBI is also working as the banker of other banks working in the country. It regulates the whole banking system of the country, keep certain percentage of their deposits as minimum reserve, works as the lender of the last resort to its scheduled banks and operates clearing houses for all other banks.

4. **Credit Control :** The RBI is entrusted with the sole authority to control credit created by the commercial banks by applying both quantitative and qualitative credit control measures like variation in bank rate, open market operation, selective credit controls etc.

5. **Custodian of Foreign Exchange Reserves :** The RBI is entrusted with sole authority to determine the exchange rate between rupee and other foreign currencies and also to maintain the reserve of foreign exchange earned by the Government. *The RBI also maintains its relation with International Monetary Fund (IMF).*

6. **Developmental Functions :** The RBI is also working as a development agency by developing various sister organisations like Agricultural Refinance Development Corporation. Industrial Development Bank of India etc. for rendering agricultural credit and industrial credit in the country.

On July 12, 1986, NABARD was established and has taken over the entire responsibility of ARDC. Half of the share capital of NABARD (Rs. 100 crore) has been provided by the Reserve Bank of India. Thus, the Reserve Bank is performing a useful function for controlling and managing the entire banking, monetary and financial system of the country.

**Regulatory and Promotional Roles of Reserve Bank of India**

**Regulatory and Promotional Roles of RBI**

*1. Regulating the Volume of Currency*
*2. Regulating Credit*
*3. Control over Commercial Banks*
*4. Determining the Monetary and Credit Policy*
*5. Mobilizing Savings*
*6. Institutional Credit to Agriculture*
*7. Specialized Financial Institutions*
*8. Security to Depositors*
*9. Advisory Functions*
*10. Policy Support*

The Reserve Bank of India (RBI) has been playing an important role in the economy of the country both in its regulatory and promotional aspects. Since the inception of planning in 1951, the developmental activities are gaining momentum in the country. Accordingly, more and more responsibilities have been entrusted with the RBI both in the regulatory and promotional area. Now-a-days, the RBI has been performing a wide range of regulatory and promotional functions in the country.

1. **Regulating the Volume of Currency :** The RBI is performing the regulatory role in issuing and controlling the entire volume of currency in the country through its Issue Department. While regulating the volume of currency the RBI is giving priority on the demand for currency and the stability of the economy equally.
2. **Regulating Credit :** The RBI is also performing the role to control the credit money created by the commercial banks through its qualitative and quantitative methods of credit control and thereby maintains a balance in the money supply of the country.
3. **Control over Commercial Banks :** Another regulatory role performed by the RBI is to have control over the functioning of the commercial banks. It also enforces certain prudential norms and rational banking principles to be followed by the commercial banks.
4. **Determining the Monetary and Credit Policy :** The RBI has been formulating the monetary and credit policy of the country every year and thereby it controls the Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR), bank rate, interest rate, credit to priority sectors etc.
5. **Mobilizing Savings :** The RBI is playing a vital promotional role to mobilize savings through its member commercial banks and other financial institutions. RBI is also guiding the commercial banks to extend their banking network in the unbanked rural and semi-urban areas and also to develop banking habits among the people. All these have led to the attainment of greater degree of monetization of the economy and has been able to reduce the activities of indigenous bankers and private money-lenders.
6. **Institutional Credit to Agriculture :** The RBI has been trying to increase the flow of institutional credit to agriculture from the very beginning. Keeping this objective in mind, the RBI set up ARDC in 1963 for meeting the long term credit requirement of rural areas. Later on in July 1982, the RBI set up NABARD and merged ARDC with it to look after its agricultural credit functions.
7. **Specialized Financial Institutions :** The RBI has also been playing an important promotional role for setting specialized financial institutions for meeting the long term credit needs of large and small scale industries and other sectors. Accordingly, the RBI has promoted the development of various financial institutions like, IDBI, ICICI, SIDBI, SFCs, Exim Bank etc. which are making a significant contribution to industry and trade of the country.
8. **Security to Depositors :** In order to remove the major hindrance to the deposit mobilization arising out of frequent bank failures, the RBI took major initiative to set up the Deposit Insurance Corporation of India in 1962. The most important objective of this corporation is to provide security to the depositors against such failures.

9. **Advisory Functions :** The RBI is also providing advisory functions to both the Central and State Governments on both financial matters and also on general economic problems.

10. **Policy Support :** The RBI is also providing active policy support to the government through its investigation research on serious economic problems and issues of the country and thereby helps the Government to formulate its economic policies in a most rational manner. Thus, it is observed that the RBI has been playing a dynamic role in the economic development process of the country through its regulatory and promotional framework.

**Reserve Bank of India and its Departments**

*Reserve Bank of India was nationalised in the year 1949*. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with headquarters at **Mumbai, Kolkata, Chennai and New Delhi**.

Local Boards consist of five members each whom the Central Government appointed for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

**The Central Board is assisted by three committees :**

1. The Committee of the Central Board **(CCB)**
2. The Board for Financial Supervision **(BFS)**
3. The Board for Regulation and Supervision of Payment and Settlement Systems **(BPSS)**

## Organisation Structure of RBI

**Central Board of Directors**

Governor
↓
Deputy Governors
↓
Executive Directors
↓
Principal Chief General Managers
↓
Chief General Managers
↓
General Managers
↓
Deputy General Managers
↓
Asstt. General Managers
↓
Managers
↓
Asstt. Managers
↓
Support Staff

To carry out the work efficiently and economically, the Reserve Bank of India is classified into central office and local office.

**The central office is divided into various departments which are as follows:**

1. Banking Department.
2. Exchange Control Department.
3. Department of Banking Operations and Development.
4. Issue Department.
5. Department of Accounts and Expenditure.
6. Economic Department.
7. Planning and Re-organisation Department.
8. Legal Department.
9. Personnel and Administration Department.
10. Agricultural Credit Department.
11. Industrial Finance Department.
12. Department of Non-banking Companies.
13. Department of Statistics.
14. Reserve Bank of India Service Board.
15. Secretary's Department.
16. The Estate Department.

The local officers are situated at seven major cities, each office comprising of the banking and issue departments. Wherever the RBI does not have a branch, the State Bank of India and its subsidiaries have been authorised to act on behalf of the RBI.

**Objectives of Reserve Bank of India**

1. To promote monetisation and monetary integration of the economy.
2. To manage currency and regulate foreign exchange.
3. To institutionalise savings through promotion of banking habit.
4. To build up a sound and adequate banking and credit structure.
5. To evolve a well-differentiated structure of institutions purveying credit for agriculture and allied activities.
6. To set up or promote several specialised financial institutions at the all-India level and regional levels to widen facilities for term finance to industry.
7. To lend support to planning authorities and governments in their efforts to accelerate the pace of economic development with stability and social justice.

**Minimum Reserve System (MRS)**

**Meaning of Minimum Reserve System**

Printing of currency notes in India is done on the basis of Minimum Reserve System (MRS). This system is **applicable in India since 1956.**

According to this system, the Reserve Bank of India **has to maintain assets of at least 200 crore rupees all the times. Out of this 200 crore, the 115 cr rupee should in the form of Gold** or gold bullion and rest 85 cr. should be in the form of foreign currencies.

After maintaining the Minimum reserve the RBI can print any number of currency notes as per the requirement of the economy. Although RBI has to take prior permission from the government.

**Monetary Policy of India**

Monetary Policy of India is formulated and executed by Reserve Bank of India to achieve specific objectives. It refers to that policy by which central bank of the country controls

(i) The supply of money, and

(ii) Cost of money or the rate of interest, with a view to achieve particular objectives.

> In the words of D.C. Rowan, "The monetary policy is defined as discretionary act undertaken by the authorities designed to influence (a) the supply of money, (b) cost of money or rate of interest, and (c) the availability of money for achieving specific objective."

Thus, monetary policy of India refers to that policy which is concerned with the measures taken to regulate the volume of credit created by the banks. The main *objectives of monetary policy are to achieve price stability, financial stability and adequate availability of credit for growth.*

Following are the main elements of the monetary policy of India :

(i) It regulates the stocks and the growth rate of money supply.

(ii) It regulates the entire banking system of the economy.

(iii) It determines the allocation of loans among different sectors.

(iv) It provides incentives to promote savings and to raise the savings-income ratio.

(v) It ensures adequate availability of credit for growth and tries to achieve price stability.

**Objectives of Monetary Policy**

**Objectives of Monetary Policy**

*i. To Regulate Money Supply in the Economy*
*ii. To Attain Price Stability*
*iii. To promote Economic Growth*
*iv. To Promote saving and Investment*
*v. To Control Business Cycles*
*vi. To Promote Exports and Substitute Imports*
*vii. To Manage Aggregate Demand*
*viii. To Ensure more Credit for Priority Sector*
*ix. To Promote Employment*
*x. To Develop Infrastructure*
*xi. To Regulate and Expand Banking*

"The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability."

**(i) To Regulate Money Supply in the Economy :** Money supply includes both money in circulation and credit creation by banks. Monetary policy is framed to regulate the money supply in the economy by credit expansion or credit contraction. By credit expansion (giving more loans), the money supply can be expanded. By credit contraction (giving less loans) money supply can be decreased.

The main aim of the monetary policy of the Reserve Bank was to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

**(ii) To Attain Price Stability :** Another major objective of monetary policy in India is to maintain price stability in the country. It implies control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

**(iii) To Promote Economic Growth :** An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

**(iv) To Promote saving and Investment :** By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

**(v) To Control Business Cycles :** Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

**(vi) To Promote Exports and Substitute Imports :** By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

**(vii) To Manage Aggregate Demand :** Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

**(viii) To Ensure more Credit for Priority Sector :** Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

**(ix) To Promote Employment :** By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.

**(x) To Develop Infrastructure :** Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.

**(xi) To Regulate and Expand Banking :** RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks. All this has expanded banking in all parts of the country.

**Instruments Of Monetary Policy**

The term monetary policy is also known as the **'credit policy'** or **credit RBI's money management policy in India**.

**Instruments of Monterey Policy**

**Quantitative Techniques**
- Cash Reserve Ratio
- Statutory Liquidity Ratio
- Bank Rate Policy
- Repo Rate
- Reverse Repo Rate
- Cell Rate
- Marginal Standing Facility
- Open Market Operation

**Qualitative Techniques**
- Marginal Requirement
- Moral Suasion
- Rationing of Credit
- Direct Action

**(A) Quantitative Techniques**

**1. Cash Reserve Ratio :** Under Section 42(1) of RBI Act 1934, All Scheduled Commercial Banks/Cooperative Banks (Public Sector/Nationalized/Private Sector/ Foreign Banks/ RRBS and Coop. Banks) in India are required to deposit a certain proportion of their deposits in the form of cash with RBI.

Cash Reserve Ratio is a specific amount of funds which the commercial banks have to keep with the Reserve Bank of India to ensure liquidity in the system.

- **If CRR Reducing :** When CRR is reduced, more funds are available to banks for deploying in other businesses because they need to keep fewer amounts with RBI. This means that the banks would have more money to play and this leads to reduction of interest rates on Loans provided by the Banks.
- **If CRR Increase :** When RBI increases the CRR, less funds are available with banks as they have to keep larger portions of their cash in hand with RBI. This means that banks will now have less money to play with.

CRR gives the Central Bank more control over the money supply in the system although commercial banks have to park only specified part of their total deposits. Latter is also known as fractional reserve banking.

**2. Statutory Liquidity Ratio :** Under Section 24 of Banking Regulations Act 1949, Every bank is required to maintain at the close of business every day, a minimum proportion **of their Net Demand and Time Liabilities as liquid assets in the form of: cash, gold and approved securities.**

The RBI Act instructs that all commercial banks (and some other specified institutions) in the country have to keep a given proportion of their demand and time deposits (NDTL or net demand and time liabilities) as liquid assets in their own vault. This is called statutory liquidity ratio.

In the definition, the liquid assets are the assets readily convertible into cash, includes government bonds, or government approved securities, gold, and cash reserve. The objective of statutory liquidity ratio is to prevent the commercial banks from liquidating their liquid assets during the time when CRR is raised.

Theoretically, SLR is a monetary policy instrument (a direct instrument). But at the practical level, SLR has helped the government to sell its securities or debt instruments to banks.

**3. Bank Rate Policy :** Bank Rate refers to the official interest rate at which RBI will provide loans to the banking system which includes commercial / cooperative banks, development banks etc. Such loans are given out either by direct lending or by rediscounting (buying back) the bills of commercial banks and treasury bills. Thus, bank rate is also known as discount rate.

When RBI increases the bank rate, the cost of borrowing for banks rises and this credit volume gets reduced leading to decline in supply of money. Increase in bank rate reflects tightening of RBI monetary policy.

When unemployment goes up - the Central Bank reduces the bank rate so that the cheap funds are available to the Commercial Bank and the Commercial Banks are able to offer loans to the unemployed youth at lower rate of interest.

Bank rate and Repo Rate are different. Bank rate usually deals with loans, whereas, **repo or repurchase rate** deals with the securities. The **bank rate** is charged to commercial **banks** against the loan issued to them by central **banks,** whereas, the **repo rate** is charged for repurchasing the securities.

**4. Repo Rate or Repurchase Rate :** Repo rate, or repurchase rate, is the rate at which RBI lends funds to banks for short periods, generally against Govt. Securities. This is done by RBI buying government bonds from banks with an agreement to sell them back at a fixed rate.

If RBI wants to make it more expensive for banks to borrow money, it increases the repo rate. Similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.

**5. Reverse Repo Rate :** Reverse Repo rate is the short term borrowing rate at which RBI borrows money from banks. The Reserve bank uses this tool when it feels there is too much money floating in the banking system. An increase in the reverse repo rate means that the banks will get a higher rate of interest from RBI. As a result, banks prefer to lend their money to RBI which is always safe instead of lending it others (people, companies etc) which is always risky.

RBI uses this tool when it feels that there is too much money floating in the Banking System.

**6. Call Rate :** Call rate - Inter bank borrowing rate - Interest Rate paid by the banks for lending and borrowing funds with maturity period ranging from one day to 14 days. Call money market deals with extremely short term lending between banks themselves. After Lehman Brothers went bankrupt Call Rate sky rocketed to such an insane level that banks stopped lending to other banks.

**7. MSF-Marginal Standing Facility :** It is a special window for banks to borrow from RBI against approved government securities in an emergency situation like an acute cash shortage

**8. Open Market Operation (OMO) :** OMO is used techniques of Monetary control. Through open market sales and purchase of govt. securities. When the RBI wants to increase the money supply, they do so by purchasing government bonds from the public in the open market.

**(B) Qualitative Techniques**

**1. Marginal Requirement :** It is the difference between the amount of loan and market value of the security offered by the borrower against the loan. Margin requirements are increased during inflation and decreased during deflation.

The marginal requirement is increased for those business activities, the flow of whose credit is to be restricted in the economy.

**2. Moral Suasion :** It is a combination of persuasion and pressure that Central Bank applies on other banks in order to get them act in a manner in line with its policy. RBI puts a pressure on the commercial banks to put a ceiling on credit flow during inflation and be liberal in lending during deflation

**3. Rationing of Credit :** Under this method, there is a maximum limit to loans and advances that can be made, which the commercial banks cannot exceed. RBI fixes a ceiling for specific categories. Such rationing is used for situations when credit flow is to be checked, particularly for speculative activities.

**4. Direct Action :** Under the Banking Regulation Act, the central bank has the authority to take strict action against any of the commercial banks that refuses to obey the directions given by Reserve Bank of India.

RBI plays an important role in controlling external shock suppose foreigner decides to make investment in Indian bonds. The seller of the bond exchanges the foreign currency into rupees from a commercial bank, the commercial bank deposits the currency in RBI which increases the assets and liabilities in the balance sheet, on the other hand, commercial bank's total reserves unchanged. In order to overcome from this situation RBI sells the securities in open market or sterilizes the economy against adverse external shocks. This process is known as sterilization. In this way, RBI stabilizes the money supply against exogenous shocks.

DID YOU KNOW ?

| | |
|---|---|
| Policy Repo Rate | : 5.15% |
| Reverse Repo Rate | : 4.90% |
| Marginal Standing Facility Rate | : 5.40% |
| Bank Rate | : 5.40% |
| CRR | : 4% |
| SLR | : 18.50% |

**Ques.** *The operations of banks and financial institutions are regulated by :*

*(A) The RBI Act 1934 only*

*(B) The Banking Regulation Act 1949 only*

*(C) Information Technology Act 2000 only*

*(D) All of the above*

**Ans.** *(D) The operations of banks and financial institutions are regulated by The RBI Act 1934, The Banking Regulation Act 1949 and Information Technology Act 2000.*

**Ques.** *Identify the years in which different phases of Bank Nationalisation took place in India :*

*(a) 1950* *(b) 1955*

*(c) 1969* *(d) 1949*

*(e) 1980*

**Codes :**

*(1) (a), (b), (c), (d)* *(2) (b), (c), (e)*

*(3) (b), (d), (e)* *(4) (c), (d), (e)*

**Ans.** *(2) These are years in which different phases of Bank Nationalisation took place in India :*

*(b) 1955 : The first major step was Nationalization of the* ***Imperial Bank of India*** *via* ***State Bank of India Act.*** *State Bank of India was made to act as the principal agent of RBI and handle banking transactions of the Union and State Governments.*

*(c) 1969 : 14 major private commercial banks were nationalized.*

*(e) 1980 : When Government of India acquired the ownership of 6 more banks, thus bringing the total number of Nationalised Banks to 20. The private banks at that time were allowed to function side by side with nationalized banks and the foreign banks were allowed to work under strict regulation.*

**Ques.** *Select the techniques of monetary control adopted by RBI from the following :*

*(a) Cash Reserve Ratio* *(b) Statutory Liquidity Ratio*

*(c) Bank Rate* *(d) Currency Rate*

***Codes :***

*(1) (a), (b), (c), (d)* *(2) (b), (c), (d)*

*(3) (a), (c), (d)* *(4) (a), (b), (c)*

**Ans.** *(4) These are the techniques of monetary control adopted by RBI from :*

***(a) Cash Reserve Ratio :*** *The Cash Reserve Ratio is the amount of funds that the banks are bound to keep with Reserve bank of India as a portion of their Net Demand and Time Liabilities (NDTL). The objective of CRR is to ensure the liquidity and solvency of the Banks.*

***(b) Statutory Liquidity Ratio :*** *Banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold and unencumbered securities. Treasury bills, dated securities issued under market borrowing programme and market stabilisation schemes (MSS), etc also form part of the SLR. Banks have to report to the RBI every alternate Friday their SLR maintenance, and pay penalties for failing to maintain SLR as mandated.*

***(c) Bank Rate :*** *Bank Rate refers to the official interest rate at which RBI will provide loans to the banking system which includes commercial / cooperative banks, development banks etc. Such loans are given out either by direct lending or by rediscounting (buying back) the bills of commercial banks and treasury bills. Thus, bank rate is also known as discount rate. Bank rate is used as a signal by the RBI to the commercial banks on RBI's thinking of what the interest rates should be*

**Ques.** *The Repo and Reserve Repo rates are resorted to by the RBI as a tool of*

*(A) Credit Control* *(B) Settlement Systems*

*(C) Currency Management* *(D) Liquidity Control*

**Ans.** *(D) The Repo and Reserve Repo rates are resorted to by the RBI as a tool of Liquidity Control.*

**Market Stabilization Scheme (MSS)**

Market Stabilization scheme (MSS) is a monetary policy intervention by the RBI to withdraw excess liquidity (or money supply) by selling government securities in the economy. The MSS was introduced in April 2004. Main thing about MSS is that it is used to withdraw excess liquidity or money from the system by selling government bonds.

**Origin of MSS**

Initially, the MSS was launched to withdraw the excess liquidity in the system that was generated as a result of the RBI's purchase of foreign currencies in the foreign exchange market. From 2002 onwards, there was huge inflow of foreign capital into India. This led to appreciation of rupee. Since appreciation is not good for exports, the RBI intervened in the foreign exchange market by buying dollars. To buy dollars, the RBI has to give rupees. In this way, high selling of rupees leads to excess liquidity (rupee) and thereby creating a potential for inflation. To overcome this situation, the RBI has sold government bonds on a general basis depending upon the volume of excess liquidity in the system. Here bonds go to financial institutions and money goes back to the RBI. This withdrawal of excess liquidity is called sterilisation.

During 2007-08, RBI sold Rs 2.5 lakh worth of securities in the financial system implying that Rs 2.5 lakh crore money supply sterilised. Following facts are important to understand MSS.

MSS is used when there is high liquidity in the system.

**Securities to be Sold under MSS**

The issued securities are government bonds and they are called as Market Stabilisation Bonds (MSBs). Thus, the bonds issued under MSS are called MSBs. These securities are owned by the government though they are issued by the RBI. It is to be remembered that government is the owner of the securities. Usually, government's securities (bonds/treasury bills) are sold or issued by the RBI as the central bank is the banker to the government.

**The peculiarity of the MSBs under MSS**

To carry out the MSS, the government lends its bonds or securities (MSBs) to the RBI. In this way, the RBI becomes a debtor to the government equal to the value of the MSBs.

The money obtained under MSS should be kept with the RBI. It should not be transferred to the government. This is because, if it is transferred, government will spend the money in the economy thereby adding to liquidity.

For the issue of MSS, there is a MoU between the government and the RBI about the total limit of MSBs to be issued by the RBI during a year. As per the latest policy, to manage liquidity in the background of demonetisation, the government has increased the limit of MSBs to 6 lakh crores.

The securities or bonds/t-bills issued under MSS are purchased by financial institutions. They will get an interest for purchasing the securities.

The money procured from selling bonds under MSS are kept with the RBI. At the same time, interest payments have to be given to the institutions who buys bond. Here, for the interest payment, the government allocates money from its budget to the RBI. This expenditure to service interest payment for MSBs is called carrying cost.

As per the latest policy, the government has increased the amount of MSBs to be issued to Rs 6 lakh crores from just 0.3 lakh crores in the context of demonetisation.

After demonetisation, huge deposits were put into the banking system. At the same time, banks can't lend it to customers as it is just temporary money. The RBI has instructed banks to keep all the additional deposits as CRR. But here, the banks will suffer losses as they have to pay interest to the depositors.

To compensate banks, the MSS policy is revived. Here, banks can put the excess money obtained from deposits in MSBs. They can get an interest payment as well.

**Measures of Money Supply**

The total stock of money in circulation among the public at a particular point of time is called money supply. The measures of money supply in India are classified into four categories M1, M2, M3 and M4 along with M0. This classification was introduced in April 1977 by Reserve Bank of India.

1. **Reserve Money (M0):** It is also known as High-Powered Money, monetary base, base money etc.

   M0 = Currency in Circulation + Bankers' Deposits with RBI + Other deposits with RBI

   It is the monetary base of economy.

2. **Narrow Money (M1) :**

   M1 = Currency with public + Demand deposits with the Banking system (current account, saving account) + Other deposits with RBI

3. M2 = M1 + Savings deposits of post office savings banks

4. **Broad Money (M3) :**

   M3 = M1 + Time deposits with the banking system

5. M4 = M3 + All deposits with post office savings banks

**Liquidity of these Measures of Money Supply**

The liquidity means how fast an instrument can be converted into cash. The liquidity of these measures are in order M1 > M2 > M3 > M4 i.e. M1 is most liquid and M4 is least liquid.

**Money Multiplier**

It is the relationship between monetary base and money supply in economy. It is the ratio of deposits to the reserves in the banking system.

$$\boxed{\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}}$$